Supreme Court, U.S.
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Nos. 86-1151 and 86-1152

In the Supreme Court of the United States

OCTOBER TERM, 1986

GARY R. FRINK, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

JAMES M. GEORGE, ET UX., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE FOURTH AND FIFTH CIRCUITS

BRIEF FOR THE RESPONDENT

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

21pp

QUESTION PRESENTED

Whether a corporation formed by the controlling partners of a real estate partnership to hold title to property, and to obtain financing that the partnership itself could not obtain, can be disregarded for federal income tax purposes on the theory that it is merely an "agent" of the partnership.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

These cases arise out of the same transaction and were consolidated for decision in the Tax Court, but appeals from the Tax Court's decision went to differ-

ent courts of appeals. The opinion of the Fourth Circuit in No. 86-1151 (Pet. App. 1a-17a) is reported at 798 F.2d 106. The opinion of the Fifth Circuit in No. 86-1152 (Pet. App. 20a-42a) is reported at 803 F.2d 144. The opinion of the Tax Court (Pet. App. 62a-136a) is unofficially reported at 49 T.C.M. (CCH) 386.

JURISDICTION

The judgment of the court of appeals in No. 86-1151 was entered on August 8, 1986, and a petition for rehearing was denied on September 16, 1986 (Pet. App. 18a-19a). On December 12, 1986, the Chief Justice extended the time for filing a petition for a writ of certiorari in No. 86-1151 to and including January 14, 1987. The judgment of the court of appeals in No. 86-1152 was entered on October 24, 1986 (Pet. App. 43a), and a petition for rehearing was denied on December 2, 1986 (Pet. App. 44a-45a). The petitions for writs of certiorari in both cases were filed on January 13, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are limited partners in the Biloxi Hotel Properties Partnership (BHPP), a Louisiana limited partnership (Pet. App. 89a). BHPP is the successor to a partnership formed in 1972 by John C. Yemelos (Yemelos) to develop a hotel in Biloxi, Mississippi (*id.* at 4a, 26a, 72a). Yemelos became one of the two general partners in BHPP, and his interest in the partnership at all times exceeded 50% (*id.* at 26a, 72a).

The partnership was unable to obtain construction financing for the hotel because the market rate

of interest exceeded the maximum rate of interest that could be charged to noncorporate borrowers under Mississippi usury law (Pet. App. 27a, 73a). Because the usury restriction did not apply to corporate borrowers, an attorney for the lender proposed that a corporation he owned be used to borrow the money. This corporation was named C.M. Conduit, Inc. (Conduit), and the attorney stated that he had used it to solve similar problems for other clients. It was proposed that Conduit would be paid a fee of $1,000.

The lender rejected that proposal, in part because it objected to the use of the word "conduit" in the corporate name. Instead, the parties agreed to use a corporation named Argo Hotels, Inc. (Argo) to hold title to the property and to borrow the funds. Pet. App. 4a-5a, 27a. Yemelos and his wife owned 100% of Argo's stock. *Ibid.*

In 1973, Yemelos caused the partnership to transfer legal title to the real estate to Argo. Argo then obtained a $6.7 million loan that was guaranteed by Yemelos and his wife (Pet. App. 28a, 80a). The loan documents did not reflect that Argo was acting for anyone other than itself. Yemelos and Argo, however, entered into a side agreement providing that Argo would act as agent for Yemelos in obtaining financing and that Argo would transact no business for its own account while it held record title to the property. The agreement did not provide for payment of any fee to Argo for its services. Yemelos agreed to indemnify Argo against all claims arising under the agreement, to fund all disbursements incident to the loan, and to guarantee the loan personally. *Id.* at 5a-6a, 27a. In 1977, Argo reconveyed the hotel site to BHPP. In 1980, the partnership paid Argo $100 (*id.* at 6a, 30a).

For its 1975-1977 tax years, BHPP reported the various expenses incurred in constructing and operating the hotel on its partnership tax returns. Petitioners in turn claimed their distributive shares of those expenses as loss deductions on their individual tax returns (Pet. App. 7a, 30a). On audit, the Commissioner disallowed those deductions, pointing out that the expenses were incurred by Argo, the corporation that borrowed the money and held title to the hotel, not by BHPP. The Commissioner therefore determined that the expenses were not deductible by petitioners. *Id.* at 7a, 30a-31a.

2. Petitioners sought redetermination of the resulting deficiencies in the Tax Court, where their cases were consolidated. The Tax Court held that Argo should be viewed as a mere "agent" of BHPP for tax purposes, and that BHPP was thus the proper entity to report the interest deductions and other expenses in question (Pet. App. 100a-122a). The Tax Court based its holding on an inference from this Court's decision in *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949). The Court there rejected the argument that the corporations at issue could be treated as mere "agents" of their common shareholder, reaffirming the rule that "a corporation formed or operated for business purposes must share the tax burden despite substantial identity, in practical operation, with its owner" (*id.* at 429). The Court went on to state, however, that this general rule would not necessarily "foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor" (*id.* at 437). The Court then went on to list certain factors that it deemed relevant to the

determination whether there was a "true" agency (*ibid.*).[1]

The Tax Court held that Argo was a "true corporate agent" as hypothesized by this Court in *National Carbide*. The Tax Court devoted much of its attention to this Court's statement that, "[i]f the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case" (336 U.S. at 437). Although Argo in the instant case was 100% owned by the controlling member of the partnership (Yemelos) and his wife, the Tax Court nevertheless concluded that Argo's relationship to the partnership was not "dependent on the fact that it was owned and controlled by the partners" (Pet. App. 102a-103a, 117a). The Tax Court reasoned that the relationship was arm's-length because Yemelos and his wife owned 100% of Argo's stock, whereas Yemelos' interest in BHPP ranged only from 62% to 69% (*id.* at 117a). The Tax Court then went on to find that

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[1] The Court in *National Carbide* described the attributes of a "true corporate agent" as follows, and its description is often broken down (*e.g.*, Pet. App. 102a-103a) into six factors (336 U.S. at 437 (footnotes omitted)):

> [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent.

each of the remaining *National Carbide* factors supported its conclusion that Argo was the agent of BHPP (*id.* at 104a-113a, 117a-118a). Accordingly, the court held that Argo's corporate existence could be disregarded for tax purposes and that the expenses in question could be deducted by the partners.[2]

3. The Commissioner appealed, and petitioners cross-appealed from the Tax Court's refusal to allow the partners to deduct all of the expenses in question (see note 2, *supra*). Based on the residences of the various petitioners, two of the cases were appealed to the Fourth Circuit, and the remainder were appealed to the Fifth Circuit. Both courts unanimously reversed the Tax Court and held that Argo was a separate taxable entity under *National Carbide*, and that Argo's existence could not be ignored for tax purposes on the theory that it was a mere "agent" of the partnership.

a. *No. 86-1151.* Adhering to its decision in *Ourisman* v. *Commissioner*, 760 F.2d 541 (1985), rev'g 82 T.C. 171 (1984), the Fourth Circuit held that the *National Carbide* test for a true agency requires proof of an arm's-length relationship between a controlled corporation and its shareholders as a prerequisite to treating the former as an "agent" of the latter (Pet. App. 1a-17a). The court concluded that there was no such arm's-length relationship here. Rejecting the Tax Court's reliance on

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[2] The Tax Court further held, however, that 11% of the expenses should be allocated to Coastal Golf, Inc., another corporation controlled by Yemelos and his wife, which owned a golf course connected with the hotel project and which the court concluded should not be treated as a mere "agent" under *National Carbide*. See Pet. App. 118a-122a.

the fact that the ownership interests in Argo and the partnership were not identical, the Fourth Circuit emphasized that Yemelos at all times held a majority interest in the partnership, was a general partner thereof, and was also in control of Argo through his ownership (together with his wife) of 100% of Argo's stock (*id.* at 9a). The fact that Argo provided its services to the partnership for no fee, the court stated, was strong evidence that the relationship was not truly conducted at arm's length (*id.* at 11a-12a). Pointing to Yemelos' dominant role in conveying the hotel site to Argo on behalf of the partnership, in defining Argo's functions, in guaranteeing its debts, and in causing it to reconvey the improved realty to the partnership in 1977 for nominal consideration (*id.* at 14a), the court concluded that Argo's relations with its supposed principal were "dependent upon the fact that it [was] owned by the principal" (*National Carbide*, 336 U.S. at 437). The court accordingly held that Argo was not a mere "agent" of the partnership under *National Carbide*.

The Fourth Circuit also rejected petitioners' contention that an agency relationship should be recognized between Argo and the partnership on the theory that this would reflect the true substance, if not the actual form, of the transaction. In the court's view, the substance of the transaction matched its form because Argo's ability to borrow money under Mississippi law was premised on its status as a corporate principal, rather than as an agent of a noncorporate borrower. In this regard, the court emphasized that the loan documents did not disclose that Argo was acting for anyone other than itself. Pet. App. 13a.

b. *No. 86-1152.* Adhering to its precedent in *Roccaforte* v. *Commissioner*, 708 F.2d 986 (1983), rev'g 77 T.C. 263 (1981), the Fifth Circuit likewise rejected the Tax Court's holding that Argo was an agent of BHPP, noting that the Fourth Circuit had already reached the same conclusion in deciding the appeals of BHPP's other partners (Pet. App. 31a-42a). The court first recited the Tax Court's findings that Argo at all times " 'was a viable and active corporation which performed business activities' " including " 'negotiating loans, entering into contracts, * * * acquiring personal property, subjecting itself to third-party claims during construction, receiving income, incurring expenses, and filing * * * tax returns' " (*id.* at 29a-30a (quoting 49 T.C.M. at 394)). The court then concluded that Argo's separate corporate existence could be ignored under *National Carbide* only if petitioners proved that the relationship between Argo (the supposed agent) and BHPP (the supposed principal) did not depend on their common ownership and control by Yemelos (Pet. App. 32a-37a (citing *National Carbide*, 336 U.S. at 437)). "The significant criteria," the court stated, "are whether the so-called 'agent' would have made the agreement if the so-called 'principals' were not its owners, and conversely whether the 'principals' would have undertaken the arrangement if the 'agent' were not their corporate creature" (Pet. App. 38a (citations omitted)). "In other words," the court stated, "[petitioners] must prove that Yemelos and BHPP dealt with Argo at arm's length" (*ibid.*).

Like the Fourth Circuit, the Fifth Circuit held that petitioners had failed to prove the arm's-length nature of Argo's relationship to the partnership.

The court emphasized that "Yemelos made no provision for compensating Argo in the nominee agreements" and that Yemelos in fact "paid Argo no compensation during the period that Argo actually held title to the assets" (Pet. App. 38a). The court also noted that "Argo acted as an agent for no one other than Yemelos and BHPP" (*id.* at 39a). The court therefore concluded that Argo was not a mere "agent" but was, under *National Carbide*, a separate taxable entity.

DISCUSSION

We believe that the courts of appeals below correctly held that Argo, the corporation formed to obtain financing and hold title to the partnership's real estate project, should not be disregarded as a mere "agent" of its shareholders for federal income tax purposes. The decision below, however, squarely conflicts with the Sixth Circuit's recent decision in *Bollinger* v. *Commissioner*, 807 F.2d 65 (1986), in which we are today filing a petition for a writ of certiorari. Because this circuit conflict can be expected to lead to disparate treatment of similarly situated taxpayers on a question of some importance in tax planning, we do not oppose the grant of certiorari in this case.

1. It is well settled that a corporation organized for a business purpose or engaged in business activity is a taxable entity distinct from its stockholders. *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436, 438-439 (1943). Moreover, as this Court stated in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974), "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated

or not." In certain circumstances, of course, the Commissioner is free to disregard the transactional form used by the taxpayer, *e.g.*, where the transaction is a sham or is employed solely for tax avoidance purposes. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465 (1935). But the Tax Court in this case found that Argo was "a viable and active corporation" (Pet. App. 96a), employed here to serve the business purpose of acquiring a loan that was not available to a noncorporate borrower like petitioners' partnership. The fact that Argo was employed for a valid business purpose provides no basis for disregarding its corporate form and treating it as a mere agent of the partnership; indeed, quite the contrary is true. Under general tax principles, therefore, Argo should be treated as a separate taxable entity, and the interest and other expenses incurred by it during 1975-1977 should be deductible by it, and not by petitioners.

Petitioner's argument that Argo should be treated as a mere conduit for tax purposes is based on a dictum in this Court's opinion in *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949). The Court there *rejected* the contention that four corporate subsidiaries were the "agents" of their common parent, holding that a true agency relationship for tax purposes requires more than the commonality of economic interest and exercise of control that inevitably inheres in the relationship between a corporation and its stockholders. Noting the principle set forth in *Moline Properties* that a corporation is an entity that is to be taxed independently of its owners, the Court stated that "[o]wnership of a corporation and the control incident thereto can have no different tax consequences when clothed in the garb of agency than when worn as a removable corporate veil" (336 U.S. at 430).

The Court in *National Carbide*, however, left open the possibility that a "true corporate agent or trustee" could handle the property and income of its owner-principal without being taxable therefor, listing several factors relevant to that determination (336 U.S. at 437). The Court made clear that a controlled corporation seeking to be recognized as an agent for tax purposes must establish that its relationship with its owner mirrors that of an agent acting for an unrelated principal. "If the corporation is a true agent," the Court stated, "its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case" (*ibid.*). As the Court recognized, the stockholders of a corporation, by virtue of their ownership interest, inevitably cause the corporation to act much as a principal, by virtue of an agency contract, would cause an agent to act, *e.g.*, by holding title to property beneficially owned by the shareholders, or by transmitting profits to them. See *id.* at 436. If such actions were sufficient to make a corporation the nontaxable "agent" of its shareholders, obviously, the entire structure of corporate taxation would collapse. Thus, the special treatment of a controlled corporation as an "agent" of its shareholders can be appropriate only where the shareholders establish that the agency relationship is unaffected by the ownership situation, and that the corporation as "agent" is in fact acting at arm's length with its shareholders as "principal."

Under the guidelines laid down by this Court, we think it clear that the courts below correctly rejected petitioners' attempt to have Argo treated as the mere "agent" of the partnership for tax purposes. Argo was created and operated to serve a legitimate business purpose, and this Court's decision in *Moline Properties* thus requires that Argo be treated as a

separate taxable entity. Moreover, the circumstances here—most obviously, the fact that Argo charged no fee—show that the supposed agency relationship between the partnership and Argo was not conducted at arm's length, but rather was "dependent upon the fact that [Argo was] owned by the principal" (*National Carbide*, 336 U.S. at 437). Most importantly, the interest expenses that Argo incurred on the $6.7 million mortgage note really were *its* expenses, not expenses of its shareholders that it was undertaking ministerially to discharge for them. That conclusion is dictated by Mississippi law, under which Argo's ability to borrow the money was conditioned on the fact that it, not the partnership, was the borrower. Petitioner's contention that Argo was acting in a mere agency capacity in taking out the loan is thus completely at odds with the premise upon which the loan was based.

For these reasons, the courts below correctly held that Argo's separate corporate existence should be recognized and given effect for federal tax purposes. Under *National Carbide*, it would be inconsistent with the two-tiered structure of corporate taxation to ignore Argo's corporate form and treat it as nothing but the agent of its shareholders. Accord, *Ourisman* v. *Commissioner*, 760 F.2d 541 (4th Cir. 1985); *Roccaforte* v. *Commissioner*, 708 F.2d 986 (5th Cir. 1983); *Harrison Property Management Co.* v. *United States*, 475 F.2d 623 (Ct. Cl. 1973), cert. denied, 414 U.S. 1130 (1974). Recognition of Argo's separate corporate existence, moreover, works no injustice or unfairness to petitioners. There is no reason why petitioners should be allowed to enjoy whatever economic advantages attach to borrowing through a corporation under state law, only to turn around and

disavow that corporate form in the hopes of claiming the corporation's expenses as tax-shelter losses on their personal tax returns.

2. Although we believe the decisions below to be correct, we agree with petitioners' statement (Pet. 14-16) that those decisions conflict with the Sixth Circuit's decision in *Bollinger* v. *Commissioner*, *supra*.[3] On facts similar to those here, the Sixth Circuit held in *Bollinger* that a corporation used to obtain loans that its controlling shareholder could not obtain because of state usury laws should be treated as an agent for tax purposes.[4] While the Sixth Circuit did not refer to either of the two decisions below,

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[3] We disagree, however, with petitioners' contention that the decisions below conflict with *Raphan* v. *United States*, 3 Cl. Ct. 457 (1983), aff'd, 759 F.2d 879 (Fed. Cir. 1985), cert. denied, No. 85-11 (Oct. 7, 1985). The Claims Court in *Raphan* reasoned that the concerns expressed in *National Carbide* are largely satisfied when the principal and agent are not under common control (3 Cl. Ct. at 462), and the court of appeals' affirmance rested on the finding that the principal and agent there were not in fact under common control (759 F.2d at 883). Since in the instant case the partnership and Argo were under the common control of Yemelos, the courts below correctly distinguished *Raphan* (Pet. App. 10a-11a, 36a). See also *Moncrief* v. *United States*, 730 F.2d 276 (5th Cir. 1984); *Carver* v. *United States*, 412 F.2d 233 (Ct. Cl. 1969).

[4] The taxpayers in *Bollinger* were investors in one or more of eight real estate ventures organized by the same general partner. One corporation, wholly owned by the general partner, purported to serve as the "agent" of seven of the ventures. The "agent" of the eighth venture was another corporation owned equally by the two partners in the venture. See *Bollinger* v. *Commissioner*, 48 T.C.M. (CCH) 1443, 1446 (1984). The corporations were not compensated for their services as agents, nor did they serve as agents for any clients other than the ventures organized by the general partner. See generally *id.* at 1444-1449, 1451.

it did state (807 F.2d at 70) that it "decline[d] to follow the Fourth Circuit's view, as expressed in *Ourisman* [v. *Commissioner*]," a decision that was cited as controlling by the Fourth Circuit below (see Pet. App. 9a). The Sixth Circuit concluded that the corporations, which held legal title to property beneficially owned by their shareholders, should be treated as agents because they "acted like agents" (807 F.2d at 70). The Sixth Circuit's rule appears to be that, so long as corporate nominees do not perform any functions that could not also have been performed by an independent agent, the separate existence of those corporations can be ignored for tax purposes (see *id.* at 67-69).

The Sixth Circuit's expansive view of the extent to which individuals may use a corporation to effect business purposes, yet ignore the existence of that corporation for tax purposes when it suits them, cannot be reconciled with the decisions below or with the relevant decisions of this Court. This Court's holding in *National Carbide* makes it clear that the circumstances in which a corporate-shareholder agency relationship can be recognized for tax purposes are extremely limited. Unless true independence is shown—that is, unless the relations between the corporation and its shareholders conform in all respects to the paradigm of an agent dealing with unrelated third parties—the supposed agency relationship manifests nothing more than the underlying ownership relationship and should not be given effect. See *Ourisman* v. *Commissioner*, 760 F.2d at 548. The Sixth Circuit's refusal to recognize this principle, in conflict with other courts of appeals and the relevant decisions of this Court, should be corrected.

3. We believe that the question presented here is sufficiently important to warrant this Court's atten-

tion. As is suggested by the number of cases already decided, the issue whether a controlled corporation is the agent of its stockholders has been a recurring one. By our reckoning, the courts of appeals during the last 15 years have considered no fewer than 17 federal tax cases construing the test for "true corporate agent" set forth by this Court in *National Carbide*. It therefore appears that, unless the conflict is resolved, a number of taxpayers may receive disparate treatment with respect to an issue that has significant tax consequences.

This issue has recently diminished in importance somewhat, at least temporarily, because of the decline in market interest rates, which in turn has reduced the impact of local usury laws. Moreover, many state legislatures have amended their usury laws either to raise the ceiling rate or to make the usury provisions inapplicable to major, commercial transactions. See generally Long, *Trends in Usury Legislation*, 34 U. Miami L. Rev. 325 (1980). These amendments, as well as federal legislation that restricts the operation of local usury laws in certain circumstances,[5] may cause the question presented to arise less frequently in the future. Quite apart from usury laws, however, there have been other problems that have prompted taxpayers to invoke the cor-

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[5] See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 511, 94 Stat. 164 (codified at 12 U.S.C. 86a) (permitting national banking associations to charge interest at a rate not exceeding five points above the Federal Reserve Board discount rate where credit of $1,000 or more is extended for business or agricultural purposes, notwithstanding more restrictive state usury laws); see also Burke & Kaplinsky, *Unraveling the New Federal Usury Law*, 37 Bus. Law. 1079, 1088-1093 (1982).

porate form, only to seek later to disavow that form for tax purposes.[6] Indeed, one of the two corporations involved in No. 86-1151 was employed for the purpose of limiting the shareholders' personal liability, not as a device for complying with state usury laws (see Pet. App. 5a). Thus, the question whether controlled corporations are to be viewed as mere agents of their owners for tax purposes is likely to continue to arise in the future, whenever the choice of the corporate form for business purposes proves to be disadvantageous from a tax standpoint. Even-handed administration of the tax laws, as well as predictability in tax and financial planning, will be enhanced by resolution of the conflict on this issue in the courts of appeals.

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[6] For example, taxpayers have sought to avoid the tax consequences attending the corporate form when it was invoked to protect property from creditors of the beneficial owners or to conceal the identity of those owners (*Paymer* v. *Commissioner*, 150 F.2d 334, 336-337 (2d Cir. 1945)); to facilitate the management or conveyance of property owned by a group of investors (*Tomlinson* v. *Miles*, 316 F.2d 710, 713 (5th Cir.), cert. denied, 375 U.S. 828 (1963)); to obtain licenses to conduct business in foreign countries (*Elot H. Raffety Farms, Inc.* v. *United States*, 511 F.2d 1234, 1239 (8th Cir.), cert. denied, 423 U.S. 834 (1975)); to avoid difficulties in administration of property that might arise upon the death of the beneficial owners (*Commissioner* v. *State-Adams Corp.*, 283 F.2d 395 (2d Cir. 1960)); or to avoid personal liability with respect to loans incurred to acquire or improve property (*Vaughn* v. *United States*, 3 Cl. Ct. 316, 317 (1983), aff'd, 740 F.2d 941 (Fed. Cir. 1984)).

CONCLUSION

The petitions for writs of certiorari should be granted, and the cases should be consolidated for briefing and oral argument.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

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